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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 001224

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SUBJECT: AZERBAIJAN-BP NEGOTIATIONS: LET THE HARDBALL BEGIN

Classified By: Ambassador Anne E. Derse, Reasons 1.4 (b,d)

¶11. (C) SUMMARY: Negotiations between the State Oil Company of Azerbaijan (SOCAR) and BP concerning the second stage of Azerbaijan energy sector development have broken down due to SOCAR's insistence on first resolving shorter-term issues involving potentially billions of dollars. Although SOCAR and BP had originally agreed to link resolution of short- and long-term issues, SOCAR's unilateral cessation of negotiations in late August signaled a hardening of Azerbaijan's negotiating position. Billions of dollars are at stake and an agreement is being forged which will decisively determine the next stage of Azerbaijani energy development. Comment: The USG is not versed in the minutiae of the commercial issues at stake and should not insert itself in negotiations. Rather, we should stress to the GOAJ that timely decision-making concerning the next stage of Azerbaijan energy sector development, with or without BP's primacy, will allow Azerbaijan to further integrate itself into the regional and global energy markets, in addition to maximizing revenues for future generations. END SUMMARY AND COMMENT.

BACKGROUND

¶12. (C) BP is the major international energy company in Azerbaijan and the company primarily responsible for achieving the first phase of post-independence Azerbaijan energy sector development. It is 34 percent shareholder and operator of the Azerbaijan International Oil Company (AIOC), the consortium responsible for developing Azerbaijan's major oil field (ACG - the Azeri, Chirraq, Gunashli field). It is operator and 25 percent shareholder of the Shah Deniz consortium developing Azerbaijan's main gas field. It is also 30 percent shareholder of the Baku-Tiblisi-Ceyhan (BTC) oil pipeline moving ACG oil and 25 percent shareholder in the South Caucasus Pipeline (SCP) moving Shah Deniz gas.

¶13. (C) In October 2006 BP Azerbaijan drafted and subsequently submitted to President Aliyev a white paper entitled, "Options for Azerbaijan: A BP Perspective on the Next Phase of Oil and Gas Development," in which it proposed a roadmap for continued BP involvement in future energy sector development. BP's strategy was to link resolution of existing contentious short-term issues, worth potentially billions of dollars, with the longer-term issues relating to the next phase of energy sector development. As Azerbaijan President Bill Schrader noted on October 1, by linking these two sets of issues BP and the AIOC Consortium were willing and fully expected to "give up some value in the short-term to gain some long-term value."

¶4. (C) One of the longer term issues for AIOC is extending the current Production Sharing Agreement (PSA) for the ACG field, which is scheduled to end in 2024. PSA extension will allow AIOC to make investments necessary to ensure maximum oil and gas extraction from the field, which would in turn increase overall GOAJ revenues and lessen the steep decline in oil-based income predicted for the period beginning o/a ¶2012.

¶5. (C) Another major long-term issue for AIOC is access to ACG non-associated (aka deep) gas, located under the area for which the Consortium now has development rights. The Consortium believes that ACG deep gas reserves are significant, approximately half that of the Shah Deniz superfield. Timely development of ACG deep gas is essential for ensuring the viability of the Southern Corridor project, i.e., that there is sufficient short- to mid-term Azerbaijani gas available for export to and through Turkey.

STATUS OF BP-SOCAR TALKS

¶6. (C) In May 2007 SOCAR (representing the GOAJ) and BP (representing the AIOC Consortium) signed an MOU agreeing to link the resolution of the extent short- and long-term issues together in a package. However, in late August 2007 SOCAR President Rovnaq Abdullayev sent a letter to AIOC Consortium members informing them that negotiations were unilaterally suspended, arguing that the short-term issues must be resolved before longer-term issues are addressed.

¶7. (C) One consequence of SOCAR's suspending negotiations in late August was that in mid-September the AIOC partners voted

BAKU 00001224 002 OF 003

to cease giving SOCAR the additional free ACG associated gas it had been providing since the previous winter. (COMMENT: According to the AIOC PSA, SOCAR is entitled receive to all associated ACG gas free of charge (excepting that which AIOC needs for operational reasons, to include gas re-injected for maximizing oil extraction). In late 2006 BP had started giving all the associated gas it could to SOCAR as a goodwill gesture, due to the delayed start of Shah Deniz gas. After winter's end, the Consortium continued to give this maximum amount of free associated ACG gas to SOCAR while negotiations were ongoing. However, as Schrader explained on October 1, after receiving the late August letter from SOCAR, AIOC partners suspended the provision of extra associated gas to SOCAR, using it instead for re-injection into the ACG field as originally intended. END COMMENT).

¶8. (C) On October 1, Murat Heydarov, Advisor to SOCAR President Abdullayev, said that Azerbaijani has "always said" that it had urgent issues centered around calculating the "real rate of return" that had to be solved before longer-term issues could be addressed. He listed the major short-term issues as follows:

- TOTAL TRANSPORTATION COSTS (TTC): Calculating TTC is important as it impacts on Netback Value (NBV): the higher the TTC per barrel of oil, the less the NBV. The PSA provides for the Contractor's allocation of Profit Oil to increase by up to five percent if TTC exceeds USD five dollars per barrel. Due to the high freight rates in the tanker market and the need to use higher cost export routes with increasing ACG production, this threshold was triggered in late 2006. In light of this event, BP adjusted the TTC calculation method. According to Heydarov, at stake is approximately USD five billion over the life of the PSA.

- PROFIT OIL SPLIT: The AIOC PSA divides exported oil into two types: cost oil and profit oil. Revenue for the former is used for operational expenses, while revenue from the latter is, as the title indicates, for profit. The PSA stipulates that in the beginning years, AIOC gets revenues from most of the profit oil, in order to compensate it for

incurred capital expenditures (Capex). Over time as Capex is recovered, a higher percentage of the profit oil goes to Azerbaijan and proportionally less to AIOC. As Heydarov explained, initially 75 percent of profit oil was going to the Consortium, with 25 percent going to SOCAR. The final split, as Capex is paid for, will be 80 percent for the GOAJ and 20 percent for the AIOC. According to SOCAR calculations, the shift in profit oil split to a fifty-fifty division was scheduled to occur in the third quarter of FY 2007, with the final change to 80 percent for the GOAJ and 20 percent for AIOC to occur in mid-2008.

- However, in April, BP told SOCAR of a change in its calculations due to a change in the underlying variables, with the 50-50 split of profit oil to occur in the second quarter of 2008 and the final shift to 80-20 to occur in mid-2009. Part of this change was to due the Consortium revising its ACG Oil Production Profile for 2008 downwards (due to drilling delays) from 950 thousand barrels per day (mpbd) to 840 mpbd. Heydarov said that a downward revision of 110 mbpd does not account for such a dramatic shift in profit oil splits, and added that these changes in profit oil split timing would involve redistribution of approximately USD 9 billion over a four year period.

- BTC TARIFF: Heydarov claimed that the actual tariff, approximately USD eight per barrel, is approximately double what has originally expected, and hence has served to lessen overall netback value.

WHAT IS SOCAR UP TO?

¶9. (C) When EnergyOff and visiting EUR/ERA EconOff McConaha discussed the negotiations breakdown with BP Azerbaijan President Schrader and BP Azerbaijan Commercial VP for Commerce Dr. Phil Home on October 1, Schrader said that the problems in large part stemmed from the fact that "no one at SOCAR has read the PSA." He said during the recent visit of UK Energy Secretary Malcolm Wicks, SOCAR President Abdullayev had excoriated BP in their meeting, referring to BP as "untrustworthy." However, in a later meeting with Wicks, President Aliyev praised BP, calling it "Azerbaijan's partner for the future." As such, Schrader mused that the unilateral cessation of negotiations was either just "Rovnaq being

BAKU 00001224 003 OF 003

stupid" or part of a calculated "good cop-bad cop" negotiating strategy. In an October 2 readout of the visiting Duke of York's meeting with President Aliyev, the UK Embassy energy officer said that the UK Embassy was fairly confident that President Aliyev was well aware of and had in fact approved Abdullayev's hardball negotiating tactics. In this light, BP Azerbaijan feels that recent complaints from Georgia about "BP putting the squeeze on Azerbaijan by cutting off gas," with its possible effects for Georgia during the upcoming winter, also springs from SOCAR and the GOAJ trying to increase the pressure on BP.

COMMENT

¶10. (C) There is a saying in this part of the world that "negotiations begin when one party walks away from the table." In this light, negotiations between AIOC and SOCAR have truly begun. Billions of dollars are at stake and an agreement is being forged which will decisively determine the next stage of Azerbaijani energy development.

¶11. (C) In terms of the Southern Corridor project, ACG deep gas is essential for ensuring that sufficient short- to mid-term Azerbaijani gas is available for export to and through Turkey. Despite recent press accounts of possible French Total development of ACG Deep Gas, the reality is that the current AIOC PSA gives the Consortium the right to match

any existing offer. Also, since developing ACG Deep Gas would have to be through the existing ACG field, insurance and indemnification issues alone would allow the AIOC Consortium as a practical matter to veto any ACG deep gas development deal made by SOCAR. It also is worth noting that President Aliyev himself has previously said in conversations with USG interlocutors that it "makes sense" for BP to take the lead on the next stage of Azerbaijan energy sector development.

¶13. (C) In our view, the USG is not versed in the minutiae of the issues at stake and should not insert itself in the negotiating process. Recognizing that negotiations of this magnitude will take time, we should nonetheless stress to the GOAJ at each opportunity that expedited decision-making concerning the next stage of Azerbaijan energy sector development, with or without BP's primacy, will allow Azerbaijan to more rapidly integrate itself into the regional and global energy markets before market opportunities are lost, in addition to maximizing revenues for future generations.

¶14. (U) Embassy will be seeking input from other AIOC Consortium members of the current negotiations and be reporting it septel.

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